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515283—59

In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 161

GRAYBAR ELECTRIC COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 3–29) are reported at 29 T.C. 818. The first opinion of the Court of Appeals (R. 160) and the second opinion denying the taxpayer's petition for rehearing (R. 177) are not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on April 13, 1959. (R. 164.) A petition for rehearing was denied on June 12, 1959. (R. 180.) The petition for a writ of certiorari was filed on July 1, 1959. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the record supports the Tax Court's finding, affirmed by the court below, that payments by the taxpayer to repurchase its stock from the estates of deceased shareholder-employees were in fact paid for the stock and not for services of the employees, with the result that the taxpayer was not entitled to deduct the payments as compensation for services under Section 23(a)(1)(A) of the 1939 Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *
>
> * * * * * *
>
> (26 U.S.C. 1952 ed., 23(a).)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.23(a)-6. *Compensation for Personal Services.*— Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compen-

sation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

* * * * *

STATEMENT

All of the taxpayer's stock is owned by approximately 60% of its employees, who have purchased it

under various plans at $20 a share. (R. 17, 24, 26.) Under the terms of the purchase plans, the stockholder-employees are obligated to offer their holdings to the taxpayer before selling to any one else, and, in the event of death, the taxpayer has an option to purchase the stock from the estates of the employees or from their beneficiaries. (R. 16–17.) Before 1938 the taxpayer paid as the repurchase price approximately the actual value of the stock, which was always more than $20. (R. 6–8, 13–14.) Since then, the purchase price has been set at the price at which the stock was issued, $20 a share. (R. 13–14.) For the taxable years involved the book value of the stock has been much in excess of this figure (R. 23) and the annual dividend on the stock amounted to $4.20 a share.

Under a corporate resolution adopted in August, 1941, and revised in September, 1947, the taxpayer has authorized the payment of "Special Death Benefits" to the estates or beneficiaries of deceased employee-stockholders whose stock is acquired by the taxpayer. (R. 20–23.) These provisions were substituted for a plan, adopted in May, 1941, providing for substantially the same payments as an "increase in the purchase price" for stock purchased from the estates of stockholders. (R. 27.) The additional payments are measured by the amount of dividends on the outstanding stock which is paid in the five years succeeding the purchase. (R. 20, 22.)

The taxpayer paid "Special Death Benefits" upon the repurchase of its stock during the taxable years in issue in the following amounts (R. 24):

1947	$77,812
1948	85,709
1949	77,294
1950	93,852

and claimed these amounts as deductions for ordinary and necessary expenses paid as compensation for services rendered. (R.24.)

The Tax Court denied the taxpayer's claimed deductions, finding and holding that the taxpayer did not meet its burden of showing that the payments were made purely for services actually rendered. (R. 29.) The Court of Appeals affirmed. (R. 163–164.)

ARGUMENT

The decision that the payments did not constitute compensation for services actually rendered is correct and is not in conflict with any decision of this Court or with any other appellate court decision.

It is clear that the burden of establishing a deduction is on the taxpayer. *Bochm* v. *Commissioner*, 326 U.S. 287. In order to meeet the requirements of Section 29.23(a)–6 of Treasury Regulations 111, *supra*, pp. 2–3, the taxpayer must establish that the payments were in fact made for services actually rendered and that they were reasonable in amount.[1] The determination whether the stipulated evidentiary facts add up to a

[1] The parties entered into a stipulation before the Tax Court (R. 39) that states that assuming, without admitting, that the amounts in question were *paid purely for services*, then the "said payments shall not be disallowed as deductions from gross income on the ground that the same constitute unreasonable allowances for compensation for personal services." The taxpayer contends that because of that stipulation (Pet. 16–17), the courts below erred in considering the fact that under the plan for "Special Death Benefits", although two employees

payment for services or a payment of additional price for the stock depends on an appraisal of the significance of these facts. *Botany Mills* v. *United States*, 278 U.S. 282, 290.

The evidence fully warrants the Tax Court's conclusion that no part of the payments in dispute was shown by the taxpayer to have been made for services rendered by the deceased employees, but, on the contrary, as the purchase price of the stock. The board of directors' meetings of the taxpayer leading up to and including the meeting authorizing the "Special Death Benefits" unequivocally show that the payments were to constitute part of the purchase price for stock of deceased employees in order to give the shareholders a higher price for their investments in the corporation. (R. 136, 146, 147, 148.) Moreover, the amount of the payments depended upon the amount of stock repurchased by the taxpayer (R. 16, 18, 20), and the only occasion for the payments was the taxpayer's repurchase of the shares (R. 18, 136, 146, 147, 148). Shareholders who performed identical services and were entitled to purchase the same amount of stock could purchase varying amounts, but when their shares were resold to the taxpayer they were to receive the payments according to the number

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rendered identical services, only the one who owned stock and sold it back to the taxpayer could receive such benefits, as indicating that the payments were for the stock and not for the value of services rendered. That contention has no merit. It is clear that the differences in treatment between stockholder and nonstockholder-employees has a direct bearing on whether the payments were in fact made for services. The stipulation was not intended to preclude consideration of such matter.

of shares resold and not as measured by the value of their services (R. 20, 27, 150–152). The more than 40% of the employees who purchased no stock at all were not entitled to any of the payments because they owned no stock to sell to the taxpayer (R. 24, 27, 105). The holding of the court below (R. 161–162, 178), based upon its review of all the facts and affirming the finding of the Tax Court, is therefore clearly supported by the record.

There is no conflict with *Commissioner* v. *LoBue*, 351 U.S. 243, and *Commissioner* v. *Smith*, 324 U.S. 177 (Pet. 8–14). Those cases involved options to corporate employees to purchase stock at prices below the market value; the employees were being given a very substantial financial benefit on the basis of their services to their employer. The petitioner's assertion that here the stock was being repurchased at a price in excess of its market value (Pet. 4, 13–14) is based on the misconception that because the contract originally obligated the employees to resell the stock at $20, that automatically sets the market value. If the petitioner is right that the obligation to resell to the taxpayer sets a ceiling on the market value, then the resolution providing for additional payment automatically raises that ceiling.[2] Actually, there is no finding by either court as to what the market value

[2] In asserting a conflict with *Helvering* v. *Salvage*, 297 U.S. 106, the petitioner fails to recognize that in that case the corporation's authority to repurchase at par was not raised to a higher figure so that it in fact fixed a ceiling for the value of the stock.

of the stock was and the petitioner cannot validly base any argument on the proposition that payments in excess of market value were authorized. The burden of proof was on the petitioner and nothing appears to show that the taxpayer paid more than the stock was worth. Therefore, the special incentive feature of *LoBue* and *Smith* is entirely absent here.[3]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY 1959.

[3] The asserted conflict with *Commissioner* v. *R. J. Reynolds Tobacco Co.*, 260 F. 2d 9 (C.A. 4) is also nonexistent. There, as here, the Tax Court and the Court of Appeals treated part of the payments made to employee-stockholders as compensation and part as a return on their stock (there a dividend rather than part of the purchase price) depending on whether it was in fact made for services or not.